

UNCERTAINTY IN THE MICROFINANCE SECTOR

The microfinance sector has been often praised and feted as the socially responsible face of Indian industry. Under the banner of 'microfinance', institutions as diverse as self help groups, societies, trusts, cooperatives, section 25 companies, non banking finance companies (NBFCs) provide credit. These institutions are in turn governed by an assorted number of legislations which may again be central or state. With all the continued emphasis on financial inclusiveness, regulating the microfinance institutions (MFIs) seems to have escaped the legislator's eye. Though the Microfinance Regulation Bill (central), which was to be introduced in 2007, was to regulate these varied MFIs (with the notable exception of NBFCs), this Bill ultimately lapsed without much media glare.

However, the microfinance sector has lately been subject to intense regulatory scrutiny. The regulatory glare on MFIs in India began with the Andhra Pradesh Ordinance (*AP Ordinance*) which blamed increasing farmer suicides on the coercive practices and high interest rates adopted by the microfinance institutions. This has witnessed a steep decline in the operating environment for MFIs.

Andhra Pradesh - MFI Regulation Bill

The Andhra Pradesh state assembly has on December 14, 2010 passed the Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Bill, 2010 (*AP MFI Bill*) regulating the MFIs without any amendment to the AP Ordinance. The AP MFI Bill has now been sent to the upper house and a final decision is expected soon. Whilst the AP MFI Bill intends to instill discipline into MFIs by inter alia requiring them to mandatorily register, maintain appropriate accounts and records and furnish prescribed records to the borrowers, submit monthly statements etc., certain other aspects including but limited to seeking prior clearance of the registering authority before granting further loans to the borrowers, stricter recovery norms like recoveries to be made only at the Panchayat house, prohibition of visit by recovery agents to house of the borrower, stringent punishments for coercive actions (very widely defined), wide powers to the registering authority to suspend or cancel the registration for failure to adhere to recovery norms may virtually cripple the day to day functioning of MFIs in Andhra Pradesh.

Petition before Andhra Pradesh High Court

Writ petitions challenging the constitutionality of the AP Ordinance were admitted by the division bench of the Andhra Pradesh High Court in late October 2010. The writ petitions primarily challenge the restrictions imposed on the conduct and procedures adopted by microfinance organizations. Instead of staying the operation of the Ordinance as requested by the petitioners, the AP High Court extended the time to comply with the registration formalities and also allowed them to continue functioning even when the registration was in process. However the writ petitions have not yet come for hearing. Therefore, since the AP MFI Bill has been passed without any amendment to AP Ordinance it is assumed that validity of the Bill is still under question.

Malegam Committee Report

The Reserve Bank of India set up a sub-committee (in late October) under the chairmanship of Y.H. Malegam to study issues and concerns in the micro finance sector. The terms of reference, amongst others include reviewing the definition of micro finance and microfinance institutions for the purpose of regulation of NBFCs undertaking microfinance and to further examine the prevalent practices of MFIs in regard to interest rates, lending and recovery practices to identify trends that impinge on borrowers' interests. Another important mandate given to the Committee is to examine and make appropriate recommendations in regard to applicability of money lending legislation of the States and other relevant laws to NBFCs/MFIs. The Sub-Committee is expected to submit its report (*RBI Report*) by the middle of January. All the stakeholders are eagerly anticipating the RBI Report to determine their future course of action

Micro Finance (Development & Regulation) Bill, 2010,

Spurred by the radar on MFIs, the Minister of State for Finance in the Parliament in late November 2010 stated that the Department of Financial Services proposes to introduce the Micro Finance (Development & Regulation) Bill, 2010. Earlier, the central government appeared keen to legislate a regulatory mechanism to govern the microfinance sector to avoid over regulation by the state governments, but most recently the finance ministry has indicated that they would wait for the RBI report and would rather not draft a hasty legislation.

It is noted that even before the spotlight on MFIs, a draft Microfinance Regulation Bill 2010 (*MFR Bill*) was circulated in early 2010 to select MFIs and comments were to be given to Chief General Manager, NABARD. This MFR Bill originally did not intended to regulate NBFCs in the microfinance sector, but in the context of Andhra Pradesh government choosing to regulate microfinance institutions in a restrictive manner, the finance ministry had indicated that they would fast track the introduction of the MFR Bill and were further contemplating the inclusion of NBFCs engaged in providing micro finance under the contours of the MFR Bill.

The proposed MFR Bill contemplates the introduction of the concept of obtaining “Registration” by the institutions carrying out microfinance activities from NABARD, irrespective of them obtaining registration from Reserve Bank of India (“RBI”) under the RBI Act, 1934. NABARD has been empowered to promote and ensure orderly growth of the micro finance services in accordance with such measures as it deems fit and the functions and roles of NABARD have been accordingly set out. The MFR Bill also proposes to appoint microfinance ombudsman to redress grievances at a preliminary level. Further, courts have been authorised to take cognizance of any offence punishable under the MFR Bill or any rules or regulations made there under, only on a complaint made by an officer or other person authorised by NABARD.

Uncertainty

The lack of clarity in the current legal framework appears to have scared away potential investors in the existing scenario. MFIs are experiencing a liquidity crisis and the credit rating of many MFIs has also plummeted in this climate. Private equity investors are expecting their returns on investment in MFIs to be drastically lowered and have further indicated that the existing environment is hostile to contemplate any new investment. We have been witness to private equity funds choosing to defer their investment in the MFI sector solely because of the regulatory uncertainty. Further the establishment of microfinance focused funds, which was in vogue a few months ago has been adversely affected.

Need for common legislation

Many of the stakeholders fear that other states might follow the example set by Andhra Pradesh since ‘money lending’ (which falls under the state list of the Seventh Schedule in the Constitution of India) is an area under which State governments are empowered to legislate. The Andhra Pradesh model would have the effect of stifling the growth of MFIs, since the procedural compulsions such as recoveries only at the panchayat house and others would be an additional burden on the operating costs of the MFIs and would have the effect of rendering the MFI model unsustainable. The lawmakers should also take into cognizance the confusion which may arise when both state and central governments are enthusiastic in regulating the MFI sector and draft the laws accordingly.

In this context, the lacunae in the current operating environment for MFIs can be filled only with an umbrella legislation governing the functioning and conduct of MFIs, irrespective of their pre existing legal structure. A common uniform legislation is a critical requirement to ensure the growth and spread of microfinance institutions.